United States Court of Appeals

for the Second Circuit

APPELLANT'S REPLY BRIEF

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74-2405

United States Court of Appeals
For the Second Circuit

GERALD L. HERZFELD,
Plaintiff-Appellee,

—against—

LAVENTHOL KREKSTEIN HORWATH & HORWATH,
Defendant-Appellant.

LAVENTHOL KREKSTEIN HORWATH & HORWATH,
Third-Party Plaintiff-Appellee,

—against—

ALLEN & COMPANY, INCORPORATED and ALLEN & COMPANY,
Third-Party Defendants-Appellants.

ALLEN & COMPANY and ALLEN & COMPANY, INCORPORATED,
Third-Party Counterclaimants-Appellants,

—against—

LAVENTHOL KREKSTEIN HORWATH & HORWATH,
Third-Party Counterclaim Respondent-Appellee.

ON APPEAL FROM THE UNITED STATES DISTRICT COURT FOR THE SOUTHERN DISTRICT OF NEW YORK

REPLY BRIEF OF LAVENTHOL KREKSTEIN HORWATH & HORWATH AS DEFENDANT-APPELLANT

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Preliminary Statement

Laventhol Krekstein Horwath & Horwath ("Laventhol") submits this reply brief as defendant-appellant to respond to issues raised by the brief of plaintiff-appellee Gerald L. Herzfeld ("Herzfeld").

Conspicuously absent from Herzfeld's brief is any reasoned attempt to sustain the judgment rendered by the Court below on the legal or factual grounds articulated in that Court's opinion. Instead, Herzfeld not only argues the case afresh, reiterating in this Court factual contentions made and rejected below, but, further, he attempts a defense of the judgment on the basis of legal criteria which did not form the basis of Judge MacMahon's decision. Thus Herzfeld, in effect, asks this Court to replace the Court below as the adjudicator of fact and to fashion a legal theory of the case to fit his reargued view of the evidence.

Understandably, appellee shies away from the inexorable implication of this argument: If the decision of the Court below cannot be defended on its legal premises or its factual findings, the judgment should be reversed and the cause remanded. Appellant agrees—indeed urges—that the decision below as framed is insupportable. But appellant does not believe it appropriate for this Court to attempt to repair the factual and legal errors of the Court below by retrying the case here, oddly enough at the instance of the appellee. Moreover, appellee's view of the case as presented in its brief here does not, appellant submits, provide any appropriate alternative basis for affirmance of the judgment below.

Rather than attempt a discursive rebuttal of the appellee's revisionist brief of the case, we take this opportunity to identify certain key fallacies in the appellee's present approach.

I.

The Monterey transactions were genuine transactions which had to be recognized in the financial statements.

Herzfeld places constant emphasis on the theory that the Monterey transactions were concocted for the sole purpose of making the private placement float. Herzfeld's case in a nutshell is that Laventhol did not take adequate steps (a) to discover and (b) to disclose adequately that the Monterey transactions were "phony." His case thus hinges entirely on the assumption that the Monterey transactions were in fact unreal. That key assumption, characterized colorfully here by Herzfeld as the "first domino," was never proved at trial and was specifically rejected in an explicit finding of fact by the Trial Court:

> "Certainly Laventhol's ascertainment of Ruderian's good reputation, coupled with his confirmation to Laventhol of Continental's bona fides in the transaction, indicated that the sale was not 'phony.' We think it quite unlikely that a man of Ruderian's good business reputation would lend his name to such a scheme. Moreover, we see no reason why Continental, with assets of only \$100,000, would pay \$25,000 to FGL [The Firestone Group, Limited] merely to create the appearance of a sale by FGL. Plaintiffs and Allen have simply failed to convince us that the Monterey transactions were 'phony' much less that Laventhol knew it." *Herzfeld* v. *Laventhol Krekstein Horwath & Horwath*, 378 F. Supp. 112, 123 (S.D.N.Y. 1974).

The District Court found that the Monterey transactions were real, arms-length transactions which were not artificially manufactured for the ulterior motive of inducing

investors to participate in the private placement.* L[illegible]en-thol, fully aware of its responsibility to purchasers [illegible] units who would read and rely on its evaluation of The Firestone Group, Limited ("Firestone Group"), sought to recognize the transactions and to reflect properly their impact. Laventhol had before it binding contracts which simply could not be ignored or discounted as worthless or of no effect. Thus Laventhol opted for the conservative treatment of recognizing in income only the $25,000 payment already made under the sales agreement, the other payment of $25,000 which was imminent and a sum which Firestone Group could recoup should the contract be breached, that is $185,000 for liquidated damages.

It is clear from the extensive discussion within the Laventhol organization regarding the treatment of the Monterey transactions that Laventhol truly sought to reflect accurately Firestone Group's income. The resistance which Laventhol exhibited to the demands of Firestone Group and Allen & Company, Incorporated and Allen & Company (collectively "Allen") to change its treatment of the Monterey transactions further illustrates that Laventhol was simply, in good faith, maintaining professional standards. There is no evidence to support Herzfeld's lurid accusations that Laventhol wilfully adopted deceptive techniques to cover up Firestone Group's misdeeds. The record does not reflect any plot by Laventhol to deceive the investors, but, rather, it shows a sincere attempt by knowledgeable and reputable auditors to frame a qualified opinion which the investors would understand.

A careful reading of Herzfeld's brief reflects the pervasiveness of his assumption that the Monterey transactions were unreal; that premise subsumes his every argu-

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* Herzfeld apparently does not seriously press here his alternative contention below that the Monterey transactions were options. In any event the Court below also specifically rejected that contention. *Her[illegible]*[illegible]*d* at 123.

ment. But the appellee failed to prove below that the Monterey transactions were contrived or "phony," and unless he means to suggest here that the Trial Court's finding of fact, set out above, was clearly erroneous (Fed. R. Civ. P. 52(a)), he has neither evidence nor finding to support the keystone of his entire argumentative structure.

II.

The doctrine of "but for" causation urged on this Court by appellee, a novel doctrine, is not a valid test of causation and the Record does not support a finding of such causation.

Herzfeld persistently contends that even though his investment decision was demonstrably based on factors other than Laventhol's report, he should nevertheless be allowed to cast liability on Laventhol for his investment losses. The unfairness of such a result is manifest since the causative nexus between Laventhol's conduct and Herzfeld's injury is conspicuously missing.

Herzfeld's recovery of damages from Laventhol would be unjust since Laventhol did not influence in any way Herzfeld's decision to buy or to retain the Firestone Group units. Herzfeld in fact concedes that "he did not read the qualified certificate nor Note 4" (Herzfeld Br. p. 3); nevertheless, upon hindsight he complains concerning alleged weaknesses in the report. In doing so, Herzfeld invents a creative but novel doctrine of causation.

Appellee's citation to authorities on causation in fact do not bind this Court to the unprecedented and insupportable theory of "but for" causation which appellee urges on this Court. Stripped of the rhetoric, Herzfeld's argument amounts only to this: Although Herzfeld never

examined the Laventhol report, the fact that Firestone Group and Allen told him that there would be no closing until an audited report confirmed the unaudited financials gave Herzfeld "a right to believe that Allen would not proceed in the absence of a satisfactory audited report" (Herzfeld Br. p. 47). Herzfeld's confessed reliance, however misguided, upon the assurances of the issuer and underwriter as to their intended behavior drives home the fallacy in appellee's case. The "but for" cause in fact of Herzfeld's decision to go through with the purchase was the conduct of Allen, not the Laventhol report. Thus, the liability for damage flowing from the purchase is clearly Allen's. On no theory of law in this Circuit can the Laventhol report be considered a causal link in the chain of facts leading to the purchase transaction. While, concededly, causation in fact based on the materiality of omitted materials, with a correlative rebuttable presumption of causation, has been applied in cases of nondisclosure (*See, e.g., Affiliated Ute Citizens* v. *United States,* 406 U.S. 128 (1972); *List* v. *Fashion Park, Inc.,* 340 F.2d 457 (2d Cir.), *cert. denied sub nom. List* v. *Lerner,* 382 U.S. 811, *rehearing denied,* 382 U.S. 933 (1965)), no case in this Circuit has employed the loose "but for" standard of causation where liability is sought to be imposed under Rule 10b-5 on the basis of alleged affirmative misrepresentations.

Proof of transactional causation has long been an essential ingredient of Rule 10b-5 claims. In order for a plaintiff to prevail, he "must demonstrate that he relied on the misrepresentations in question when he entered into the transaction which caused him harm." *Schlick* v. *Penn-Dixie Cement Corp.,* 507 F.2d 374, 380 (2d Cir. 1974), *cert. denied,* 44 L. Ed. 2d 467 (1975).

Herzfeld's discussion of privity is not to the point. Appellant concedes that causation may be present notwith-

standing the lack of privity between a plaintiff and a defendant. *Shapiro* v. *Merrill Lynch, Pierce, Fenner & Smith,* 495 F.2d 228, 239 (2d Cir. 1974). But *Shapiro,* cited by Herzfeld (Herzfeld Br. p. 46), says nothing to contradict the argument which Laventhol has consistently maintained in the Court below and here: This record is devoid of the required proof of causation in fact between the Laventhol report and the transaction which led to Herzfeld's injury. *See Titan Group, Inc.* v. *Fagger,* [1974-1975 Transfer Binder] CCH Fed. Sec. L. Rep. ¶ 95,042 (S.D.N.Y. 1975); *Globus* v. *Law Research Service, Inc.,* 418 F.2d 1276 (2d Cir. 1969), *cert. denied,* 397 U.S. 913 (1970).

Additionally, Herzfeld's reliance upon *Competitive Associates, Inc.* v. *Laventhol Krekstein Horwath & Horwath,* [1974-1975 Transfer Binder] CCH Fed. Sec. L. Rep. ¶ 95,090 (2d Cir. 1975), is inappropriate. In *Competitive Associates,* the Court reversed summary judgment for defendant where plaintiff alleged a comprehensive scheme to defraud. The Court there made clear that it would accept indirect proof of reliance but only because of the particular nature of the allegations which the Court perceived to include charges of collateral wrongdoing sufficient to constitute a common scheme or course of business. No such allegation has been made here.

Since the instant case is a simple "misrepresentation" case and the Court so found, the established law in this Circuit which requires direct proof of transactional causation is controlling here. *Chris-Craft Industries, Inc.* v. *Bangor Punta Corp.,* 480 F.2d 341, 373 (2d Cir.), *cert. denied,* 414 U.S. 910 (1973), cited by Herzfeld (Herzfeld Br. p. 45) is not to the contrary. In that case Chris-Craft Industries ("CCI"), a disappointed offeror in a tender and exchange offer for control of the target company, Piper Aircraft Corporation ("Piper"), brought suit under § 14(e) and

Rule 10b-5 alleging that Bangor Punta Corporation ("BPC") and its underwriter, First Boston Corporation ("First Boston") had joined with Piper's management to mislead the Piper shareholders through dissemination of false and misleading information. CCI argued unsuccessfully in the lower court that but for the securities laws violations of BPC and First Boston, the Piper shareholders would have accepted the offer of CCI and not BPC.

In reversing the lower court on the causation issue, this Court applied the *Mills-Ute* test of causation to the particular facts of a tender offer where the volitional acts which caused the transaction also gave rise to plaintiff's injury (*Affiliated Ute Citizens, supra; Mills* v. *Electric Auto-Lite Co.,* 396 U.S. 375 (1970)). It was in this context that the Court said:

> "CCI need not show that it relied upon the deception. CCI must show that there was a misrepresentation upon which the target corporation shareholders relied and that this was in fact the cause of CCI's injury. . . .
>
> "We have held that reliance is established in a Rule 10b-5 action if the 'misrepresentation is a substantial factor in determining the course of conduct which results in [the recipient's loss].'
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> * * *
>
> "[In the instant case, it] would be impractical to require CCI to prove that each individual Piper shareholder who failed to trade for CCI's stock, or who traded for BPC's stock, relied upon defendant's misrepresentations in doing so. These impracticalities are avoided by establishing a presumption of reliance where it is logical to presume that reliance in fact existed." *Chris-Craft, supra* at 373, 375.

Obviously the Court was not by this language reading proof of reliance out of Rule 10b-5 misrepresentation actions; the Court was merely adapting the well-settled law to permit indirect proof of reliance where the facts before it precluded direct proof. Moreover, the Court's entire discussion of the causation issue is instinct with the proposition that a causal nexus must be shown between an alleged violation, the transaction and plaintiff's economic loss. Thus the Court reasoned that the *Mills-Ute* presumption of reliance, ordinarily applied only in nondisclosure cases, was appropriate in a case involving widespread market behavior where an inference of causation could appropriately be drawn from the found facts. The circumstances in a private placement with participation of sophisticated investors in an alleged direct misrepresentation case are distinctly different and make the more direct proof of causation habitually required in such cases a requisite. *Titan Group, Inc., supra; Schlick, supra.*

The record reveals no such proof of causation as is required in this Circuit. By Herzfeld's own admission, Herzfeld bought his units before issuance of the report (25-27e; 316-317e; 326a); Herzfeld never bothered to read the Laventhol report when he received it (325-326a; 329a); and the documents that he *did* read and on which he based his decision were those prepared by Allen and Firestone Group. The balance sheet and income statement attached to the Note and Stock Purchase Agreement, all of which pre-dated the Laventhol report, and on all of which Herzfeld admits he heavily relied in deciding to invest, were later bitterly characterized in the Herzfeld brief as "pure fiction" (Herzfeld Br. p. 5).

Herzfeld describes the generation of his interest in the Firestone Group investment on pp. 6-7 of his brief as follows:

> "Plaintiff [Herzfeld] was introduced to the FGL investment by his friend, David Baird, a member of the firm of Baird, Patrick & Co., who reported to plaintiff that Charles Allen had described the Firestone investment as 'one of the hottest deals he had ever seen' [284a]. Irwin Kramer, another friend of plaintiff, who was Charles Allen's son-in-law and an officer of Allen, was similarly enthusiastic about the FGL securities [309a]. Herzfeld, after talking with Baird and Kramer, was impressed by their enthusiasm [289a].
>
> * * *
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> "The Purchase Agreements forwarded to Herzfeld and Baird for execution, were accompanied by an FGL letter, dated November 21, 1969, stating that the closing was scheduled for December 16, 1969, 'to permit the preparation of audited financial statements, as at and for the eleven months ended Novem-30, 1969, copies of which will be delivered to you' [E5]. The letter added that these 'audited statements will serve as the basis for confirming the unaudited Projected Financial Statements annexed to the Note and Stock Purchase Agreement as Exhibit B' [E5]. The testimony further established that in the negotiations between Allen and FGL, it had been made 'a condition' of the investment by Allen and its investors that 'there had to be an audit statement' by 'Laventhol' [810a, 811a].
>
> "Herzfeld testified that he 'read both the balance sheet and the income statement' included in Exhibit B, and 'paid particular attention to the income state-

> ment'; which indicated 'that this was a very profitable company and earnings were approximately $2 a share for the period ending November 30, 1969' [274a, 275a]." Herzfeld Br. pp. 6-7.

Despite Allen's assurance that the audited financial statements would confirm the unaudited statements, such was not the case. The Laventhol report did not confirm the unaudited statements (977a), but despite the discrepancies, Allen went forward with the placement. Herzfeld's reliance on Allen to forebear from proceeding with the placement in the absence of confirmation was clearly misplaced.

Although Herzfeld did rely on Allen, the Court below specifically found that Herzfeld did not rely on the Laventhol report when making his original purchase:

> "It is true that his [Herzfeld's] initial interest in the securities was generated by sources other than Laventhol and that he actually purchased both units before seeing the audited report." *Herzfeld, supra* at 128.

Herzfeld's contention that the Laventhol report constituted the transactional cause of his original purchase of the units, then, flies in the face of the well-settled law and of the plainly established facts.

But, argues Herzfeld, he "need not rely upon this proof" (Herzfeld Br. p. 48); he goes on to argue, in essence, that upon receipt of the Laventhol report accompanied by the Firestone Group letter (28e), he relied upon the report in deciding not to accept the offer to rescind contained in the letter (Herzfeld Br. pp. 24-25; 48-49). This argument, too, runs afoul of the facts as shown at trial which established convincingly that Herzfeld's reliance at this juncture was

on the Firestone Group letter, and not on the Laventhol report.

More important, Herzfeld's argument that he forebore to rescind on the strength of Laventhol's report is demolished as a matter of law by the decision of the Supreme Court in *Blue Chip Stamps* v. *Manor Drug Stores,* [1974-1975 Transfer Binder] CCH Fed. Sec. L. Rep. ¶ 95,200 (U.S. June 9, 1975).

In *Blue Chip,* the Supreme Court squarely held that a plaintiff could not sustain a claim for damages under Section 10(b) if he was neither a purchaser nor seller of securities in connection with the violation complained of. Herzfeld, of course, had committed himself to buy the units in November and the transaction had been closed on December 16. The next day, Herzfeld received the Firestone Group letter containing the offer to rescind, together with the Laventhol report. At that point, Herzfeld was in possession of an offer by Firestone Group to buy his units. He did not accept that offer. He did not sell his units. As to any investment decision *not* to sell made by him after receipt of the Laventhol report (and, for this issue, regardless of what he did or did not do with that report), he is squarely in the legal position of the plaintiffs in *Blue Chip.*

The Court there identified precisely the difficulty of establishing causation in fact, which is so vexatious in this case, as a critical factor in its adherence to the rule announced by this Court in *Birnbaum* v. *Newport Steel Corp.,* 193 F.2d 461 (2d Cir.), *cert. denied,* 343 U.S. 956 (1952). Speaking in the context of a suit against an issuer based upon a prospectus, the Court held, in language equally applicable in a suit against an accountant based upon financial statements:

> "Plaintiff's proof would not be that he purchased or sold stock, a fact which would be capable of docu-

> mentary verification in most situations, but instead that he decided *not* to purchase or sell stock. Plaintiff's entire testimony could be dependent upon uncorroborated oral evidence of many of the crucial elements of his claim, and still be sufficient to go to the jury. The jury would not even have the benefit of weighing the plaintiff's version against the defendant's version, since the elements to which the plaintiff would testify would be in many cases totally unknown and unknowable to the defendant. The very real risk in permitting those in respondent's position to sue under Rule 10b-5 is that the door will be open to recovery of substantial damages on the part of one who offers only his own testimony to prove that he ever consulted a prospectus of the issuer [opinion of an accountant], that he paid any attention to it, or that the representation contained in it damaged him." *Blue Chip, supra* at 97,961.

Herzfeld has done here just what the Supreme Court condemned: He waited on the sidelines without risk and only claimed that inaccuracies in disclosure caused him not to sell to Firestone Group when it developed that his investment was unsatisfactory.*

Thus, both the square holding and policy considerations articulated in *Blue Chip* preclude recovery for Herzfeld as a matter of law in respect of any supposed dependence by

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* Mr. Justice Powell, concurring, identified the issue as being whether Section 10(b) embraced *offers* to purchase or sell. On an analysis of the statutory language and policy, Mr. Justice Powell concluded that the statute did not embrace such offers. The Firestone Group offer to rescind was factually, legally and economically no more and no less than an offer to purchase and on such analysis was not within the definitional framework of Section 10(b).

him on the Laventhol report in his conclusion not to sell his units back to Firestone Group.

In short, as to the investment decision in which he became a purchaser, he did not and could not have relied on the Laventhol report; as to the investment decision he made after receiving the Laventhol report, he is neither a purchaser nor seller.

His position on the issue of reliance on Laventhol's report in his decision not to rescind fails as well as a matter of fact. Herzfeld has clearly failed to prove by a preponderance of competent evidence any reliance at all on Laventhol's report in that decision.

Consistent with Herzfeld's own account of his purchase of the units, the Court found that Herzfeld, after purchasing, only glanced at one page of the certified financial statements and failed to read footnote 4 and other explanatory material. Thus Herzfeld never knew that the opinion was materially qualified, nor was he ever aware of Laventhol's explanation of the Monterey transactions. It is plain, then, that he could not have relied to his detriment on such explanation. To the contrary, all the evidence demonstrates that Herzfeld had practically no interest in Laventhol's report and that he did not base his decision to refrain from rescinding on the report.

Rather, it is clear that Herzfeld made his decision to hold his units on the basis of what Firestone Group's letter to him said. (See Appellant's Br. pp. 21-28 for a discussion of this issue.) Herzfeld now devises a new argument to attempt to avoid the exculpatory effect of that evidence.

His argument now is that Laventhol's treatment of the Monterey transactions as real economic events gave Firestone Group and Allen the tool they needed to issue the

misleading letter. But this argument once again leans entirely on the rejected factual assertion that the Monterey transactions were not real. Once it is understood that there is no proof of their unreality, the question is solely how best to express the reality. Here the veneer supplied by Firestone Group and Allen to the discouraging Laventhol treatment becomes the critical intervening causative factor. The record clearly shows that it was Allen and Firestone Group who pushed the private placement forward in spite of—not because of—the unfavorable Laventhol report. Any so-called ''flim-flam'' operated by Allen and Richard M. Firestone in the letter dated December 16, 1969 (28e) to promote the placement was not the fault of Laventhol. Neither should Laventhol bear responsibility for the false impression left by Allen when it offered to replace any cancelled subscription should a purchaser find that Firestone Group's prospects were less favorable than the purchaser expected.

III.

Laventhol's qualified report was not misleading and was fully in accord with generally accepted accounting principles.

Herzfeld is obviously confused regarding the standards to which accountants must adhere. At one point, Herzfeld cites *List* v. *Fashion Park, Inc., supra,* 340 F.2d at 462-463, as purported authority for the assertion that the duty of disclosure imposed upon an independent auditor ''is at least as great as that imposed upon a principal in the transaction'' (Herzfeld Br. p. 39). *List* holds nothing of the sort.

In *List,* insiders had purchased the stock of Fashion Park Corporation without disclosing that the board of directors had resolved to sell or merge the company and had a prospective purchaser on the horizon. On plaintiff's

appeal after rejection of his claim of damage from nondisclosure, this Court affirmed the trial court. Characterizing the facts before it as a case of total nondisclosure, the Court opined regarding the applicability of Rule 10b-5:

> "Rule 10b-5 in cases like this . . . precludes not only the conveyance of half truths by the buyer which actually misled the seller; but, as well, failure by the buyer to disclose the full truth so as to put the seller in an equal bargaining position with the buyer." *Id.* at 462.

As this passage—which plaintiff has distorted with interpolation—indicates, the dictum in *List* is plainly inapposite here. First, *List* said nothing about accountant's liability. Second, *List* was a case involving total nondisclosure; *Herzfeld*, on the other hand, is grounded on the theory of affirmative misrepresentation. Finally, the principle for which plaintiff erroneously cites *List* is clearly contradicted by the principles of accounting set forth in *Auditing Standards and Procedures: Statements on Auditing Procedure No. 33* (1963) ("SAP 33")—the principles prevailing in December, 1969 when Laventhol certified Firestone Group's financial statements.*

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* Herzfeld similarly plays fast and loose with his use (Herzfeld Br. p. 55) of *Escott* v. *Barchris Construction Corp.*, 283 F. Supp. 643 (S.D.N.Y. 1968). In that case, the Court found the accountant liable in connection with S-1 review because the partner in charge was too easily satisfied with glib answers to his inquiries, *which were directed solely to one officer of the Barchris company itself.* Here, Laventhol did not content itself with inquiries directed at management but made independent inquiries concerning the substance of the Monterey transactions to ascertain their economic reality, and resisted the insistent demands of management to express that reality in a manner favorable to management. In the very passage selectively quoted by Herzfeld, he omits the critical norm established by the *Escott* Court: "Accountants should not be held to a standard higher than that recognized in their profession" (*Id.* at 703). Omitting that essential statement of the standard, Herzfeld contends for a standard of investigation and disclosure substantially higher than that recognized in the profession. *Escott,* fairly read, supports Laventhol's position, not Herzfeld's.

SAP 33, drafted by the Senior Technical Committee of the American Institute of Certified Public Accountants, sets forth the recognized responsibilities and functions of an independent auditor.* It clearly distinguishes the secondary responsibilities of an accountant from management's primary responsibility for an accurate accounting system:

> "The subsequent discovery that fraud existed during the period covered by the independent auditor's examination does not of itself indicate negli-

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* "Management has the responsibility for adopting sound accounting policies, for maintaining an adequate and effective system of accounts, for the safeguarding of assets, and for devising a system of internal control that will, among other things, help assure the production of proper financial statements. The transactions which should be reflected in the accounts and in the financial statements are matters within the direct knowledge and control of management. The auditor's knowledge of such transactions is limited to that acquired through his examination. Accordingly, the fairness of the representations made through financial statements is an implicit and integral part of management's responsibility. The independent auditor may make suggestions as to the form or content of financial statements or he may draft them in whole or in part, based on the management's accounts and records. However, his responsibility for the statements he has examined is confined to the expression of his opinion on them. The financial statements remain the representations of the management.

* * *

"The auditor recognizes that fraud, if sufficiently material, may affect his opinion on the financial statements, and his examination, made in accordance with generally accepted auditing standards, gives consideration to this possibility. However, the ordinary examination directed to the expression of an opinion on financial statements is not primarily or specifically designed, and cannot be relied upon, to disclose defalcations and other similar irregularities. . . . [A]lthough the discovery of deliberate misrepresentation by management is usually more closely associated with the objective of the ordinary examination, such examination cannot be relied upon to assure its discovery. The responsibility of the independent auditor for failure to detect fraud (which responsibility differs as to clients and others) arises only when such failure clearly results from failure to comply with generally accepted auditing standards." SAP 33, Ch. 1, ¶¶ 2, 5 (1963).

gence on his part. He is not an insurer or guarantor; if his examination was made with due professional skill and care in accordance with generally accepted auditing standards, he has fulfilled all of the obligations implicit in his undertaking." SAP 33, Ch. 1, ¶ 8 (1963).

It is not necessary for Laventhol to shed "crocodile tears," as Herzfeld has suggested, ab[illegible] its treatment of the Monterey transactions. Lav[illegible]nduct was in complete accordance with SAP 33 [illegible] *supra* and its further provision for qualification of an opinion as set out in the margin below.* Laventhol inserted the words "subject to" in its certification with the knowledge that a reasonable investor would be forewarned of the uncertainties of collection of the deferred profit reflected by the qualification. In this Laventhol was fully in accord with the proper form for such a qualification prescribed by SAP 33.

Herzfeld's argument, without benefit of apposite authority, would significantly reorder the obligations of issuers and auditors as to the interpretative data to be made available to investors. For reasons already argued (Appellant's Br. pp. 33-39), creation of this expansive view of the disclosure obligations of auditors is unsound in law and policy and should be rejected.

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* "The management of a company ordinarily is expected to evaluate matters affecting financial position and results of operations. In cases where the probable effects of a matter are not reasonably determinable at the time of the opinion, such as in the case of certain lawsuits, tax matters, and other contingencies which may have a material effect upon the financial statements, and the final outcome is dependent upon the decision of parties other than management, the independent auditor should appropriately qualify his opinion. In such instances, use of the phrase 'subject to' is appropriate." SAP 33, Ch. 10, ¶ 45 (1963).

IV.

At Laventhol's insistence the erroneously distributed unqualified first report was withdrawn and a qualified report was substituted because Laventhol refused to issue an unqualified opinion.

Herzfeld attempts to draw sinister connotations from Laventhol's withdrawal of an unqualified report and later issuance of the qualified Laventhol report. To that end, he mischaracterizes the events surrounding the substitution of the qualified opinion and implies that Laventhol's purpose was to deceive the investors. Nothing could be further from the truth.

The Court below found the substitution of reports to be of no particular significance:

> "Laventhol substituted a new report which stated that it fairly reflected FGL's financial condition 'subject to the collectibility of the balance receivable on the contract of sale (see Note 4 of Notes to Financial Statements).' This addition was the only change in the report, and it was this 'qualified' opinion which was seen by the investors, including Herzfeld." *Herzfeld, supra* at 121.

The record fully justifies the conclusion that Laventhol's only concern when it substituted the qualified report for the erroneously issued first report was to make clear to investors that its opinion was not "clean." That was the only intent Laventhol had. Herzfeld's interpretation of the rendition of the qualified report, which so distressed the client and the underwriter, as an act of servility by Laventhol towards them stands the record on its head.

Herzfeld's attempts to draw similar dark inferences from a conjured distinction between the definitions of

"unrealized gross profit" and "deferred gross profit"—the latter used in the qualified report, the former in the unqualified report. There is no evidence in the record that the change in language was of any import whatsoever.* Laventhol gave no consideration to the change in language because the terms are interchangeable and are so used by recognized accounting authorities.

The most authoritative work on accounting definitions is Eric L. Kohler's *A Dictionary for Accountants* (4th ed. 1970), which defines deferred revenue (or income) as:

> "(a) Revenue or income received or recorded before it is earned, *i.e.*, before the consideration is given, in whole or in part, for which the revenue is or is to be received; also known as *deferred credit, unearned income*, and *unrealized revenue.*
>
> * * *
>
> "(b) Income subject to adjustment or held in suspense until offsetting charges have been determined and deducted, until a period of time has been completed, or until it has been fully identified." *Id.* at 144.

Kohler's definition clearly indicates that "deferred" revenue or income is properly interchangeable with "unrealized" revenue.

Other authoritative accounting texts are in complete accord: Meigs, Johnson & Keller, in their presentation of installment sales in financial statements—and of course the Monterey transactions were installment sales—recommend "a deferred gross profit account" when "the profit element of an installment sale has not yet been realized." *Advanced Accounting* 184 (1966). And in their model of a correctly drawn financial statement, the authors enter "de-

* Plaintiff's expert witness was not asked to and did not opine upon the supposed distinction of which Herzfeld now attempts to make so much.

ferred gross profit on installment sales."* *Accord,* Finney & Miller, *Principles of Accounting, Advanced* 107, 122 (5th ed. 1975); Meigs, Mosich & Larsen, *Modern Advanced Accounting* 450-51 (1975). These authorities expose Herzfeld's distinction between "unrealized" and "deferred" income, upon which he bases so much of his insinuations of deliberate misconduct, as much ado about nothing.

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* Exemplary is the following income statement, set forth in *Advanced Accounting, supra* at 175. Noteworthy is the juxtaposition of "deferred gross profit" and "realized gross profit"—a juxtaposition which, along with the exclusion of the "Deferred gross profit . . ." amount from "Total Realized Gross Profit," further signifies that "deferred" actually means "unrealized" and vice versa.

GRIDLEY COMPANY
INCOME STATEMENT
For the Year Ended December 31, 1969

	Installment Sales	Other Sales	Totals
Sales	$ 900,000	$ 300,000	$1,200,000
Cost of Sales	450,000	225,000	675,000
Gross profit	450,000	75,000	525,000
Less:			
Deferred gross profit on installment sales made in 1969	$ 150,000		$ 150,000
Realized gross profit on 1969 sales	300,000	$ 75,000	375,000
Add:			
Realized gross profit based on prior years' installment sales (see Note A):			
Installment contracts, 1967			24,000
Installment contract, 1968			58,500
Total Realized Gross Profit			$ 457,500

CONCLUSION

The Amended Judgment of the District Court should be reversed and the cause remanded to the District Court with instructions to enter judgment dismissing the complaint, or, in the alternative, with instructions to vacate the Amended Judgment and to hold a new trial.

Respectfully submitted,

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